IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-1724

HARRY G. BURKS, JR., *et al.*,

Petitioners,

v.

HOWARD M. LASKER, *et ano.*,

Respondents.

RESPONDENTS' BRIEF IN OPPOSITION TO THE PETITION

JOSEPH H. EINSTEIN
469 Fifth Avenue
New York, New York 10017

Attorney for Respondents

ARANOW BRODSKY BOHLINGER
BENETAR & EINHORN
STEVEN MALLIS
HERBERT A. EINHORN
DAVID J. SWEET
TERENCE L. BLACKBURN
469 Fifth Avenue
New York, New York 10017

Of Counsel

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Petitioners,

v.

HOWARD M. LASKER and IRVING GOLDBERG,

Respondents.

RESPONDENTS' BRIEF IN OPPOSITION TO THE PETITION

Question Presented

Can minority directors of a registered mutual fund who were nominated by the majority directors of the fund to be "independent" directors pursuant to the requirements of the Investment Company Act terminate a validly commenced nonfrivolous stockholder's derivative action against the fund's majority directors and its investment adviser based upon violations of the Act and other breaches of fiduciary duties?

Statutory Provisions Involved

The following statutory provisions are involved:

Section 36 of the Investment Company Act as it existed prior to December 14, 1970, Act of Aug. 22, 1940, ch. 686, Title I, §36, 54 Stat. 841;*

Section 13(a)(3) of the Investment Company Act, codified in 15 U.S.C. §80a-13(a)(3) (1976) (at p. 1027);

Section 206 of the Investment Advisers Act, codified in 15 U.S.C. §80b-6 (1976) (at p. 1070);

Rule 23.1 of the Federal Rules of Civil Procedure.

Statement of the Case

This is a stockholder's derivative action brought on behalf of Fundamental Investors, Inc. ("the Fund"), a federally regulated mutual fund, seeking redress for investment losses of $20 million in connection with the Fund's purchase and retention of commercial paper issued by the now bankrupt Penn Central Transportation Company. The Fund's investment adviser and certain of the Fund's present and former directors are charged with gross misconduct, gross abuse of trust, fraud and deviation from the Fund's fundamental investment policy. The claims asserted arise under the Investment Company Act of 1940, the Investment Adviser's Act and the common law.

The Fund is an open-end mutual fund and is one of seven funds within the Anchor Group of Mutual Funds.

* Petitioners and the *amici* cite and refer to the current statute, commonly referred to as Section 36 of the Investment Company Act, codified in 15 U.S.C. §§80a-35(a) and (b). That statute was enacted after the events giving rise to this litigation occurred. Petitioners have violated Rule 23(1)(d) of this Court by failing to reproduce any of the statutes involved.

Petitioner Anchor Corporation ("Anchor") is the Fund's investment adviser. The individual petitioners are the directors who were members of the Fund's board at the time the acts complained of occurred.

During the period November 28 through December 8, 1969, the Fund purchased $20 million worth of 270-day Penn Central commercial paper in four separate transactions. The paper was purchased from Goldman, Sachs & Company, which Anchor believed had conducted a credit analysis of the issuer. Goldman, Sachs sold the paper as a principal out of its own inventory. Notwithstanding its duty, as a highly paid adviser, to render independent advisory recommendations, Anchor concededly did not conduct any independent analysis or investigation, either at the time of purchase or thereafter. In this regard the Court of Appeals stated:

> "It is undisputed that Anchor never made any independent investigation of Penn Central's financial situation before the Fund's purchase of the notes. Moreover, although reports of Penn Central's operations in early 1970 showed mounting losses, it was not until May that the Fund officers made any attempt to resell any part of the notes to Goldman, Sachs, or otherwise to realize on the investment."*

Not only were the purchases made without any investigation but, in addition, two primary investment policies of the Fund itself were violated:

The Fund failed to obtain a required buy-back commitment;

* *Lasker* v. *Burks*, 567 F.2d 1208, 1209 (2d Cir. 1978). Indeed, even staggering first quarter 1970 losses of $62.7 million reported in the *Wall Street Journal* on April 23, 1970 failed to prompt Anchor to action. It is difficult to imagine a more blatant unawareness of an impending disaster by a highly paid and purportedly sophisticated adviser than that exhibited by Anchor.

The Fund failed to restrict its holdings to not more than ten (10%) percent of the issue.

Based upon the facts before it, the Court of Appeals concluded:

> "From what this record discloses regarding the Fund's investment in Penn Central notes on Anchor's advice, we cannot say that, following a trial on the merits the defendants would be found free from liability for the Fund's losses." 567 F.2d at 1210.

After the Penn Central debacle in June 1970, the Fund determined to proceed against Goldman, Sachs and adopted a resolution to that effect in November 1970. The November 1970 resolution specifically held in abeyance the question of whether to proceed against Anchor.*

The present action was commenced in February 1973** but was stayed pending determination of the Fund's action against Goldman, Sachs. That action was settled in July 1974 with the Fund recouping only approximately twenty-five (25%) percent of the $20 million dollars which it lost.

Thereafter, an alleged independent minority of the board, acting on the advice of Special Counsel, determined that this action should be abated because further prosecution was not in the best interests of the Fund. A motion was made and the District Court dismissed*** but was reversed by the Court of Appeals, which concluded that the alleged disinterested directors lacked the power to terminate this litigation.*

* It must be remembered that Anchor dominated the Fund.

** The complaint alleged that demand was unnecessary. Defendants have never disputed that allegation. Because of the procedural maneuvers of the defendants, the complaint has yet to be answered and plaintiffs have not had any discovery on the merits.

*** The dismissal came after limited discovery led the District Court to conclude that the minority was "independent and disinterested." *Lasker* v. *Burks,* 426 F. Supp. 844 (S.D.N.Y. 1977).

POINT I

There Is No Reason for Review by This Court Since the Result Below Is Consistent With Well Accepted Principles Governing the Maintenance of Derivative Actions.

Petitioners suggest that the determination of the Second Circuit, which prevented a *minority* of a board from abating a validly commenced derivative action, somehow flies in the face of existing precedent. On the contrary, it is well settled that even a *majority* of a board cannot abort a validly commenced derivative action which has proceeded beyond the threshold issue of demand, as has this case. See *Birnbaum* v. *Birrell,* 17 F.R.D. 409 (S.D.N.Y. 1955); *Berger* v. *Dyson,* 111 F. Supp. 533 (D.R.I. 1953); *Denicke* v. *Anglo California Nat. Bank,* 45 F. Supp. 524, 529 (N.D. Cal. 1942), *aff'd,* 141 F.2d 285 (9th Cir.), *cert. denied,* 323

* The tactic adopted to obtain dismissal was carefully planned and orchestrated. By November 1970, Anchor was aware that the Fund had potential claims against it. In July 1971, at the suggestion of Mr. Haire (the President of the Fund and Chairman of Anchor) a committee to screen who would become independent directors of the Fund was created. This committee was dominated by Haire and consisted solely of defendants except in one situation where two of the three members were defendants. The independent directors who eventually determined to seek dismissal of this action were nominated by the full board (including the malefactors) after prior screening by that committee. The "independent" directors serve not only on the Fund's board but on the boards of its sister funds, each receiving remuneration of approximately $11,000 to $13,000 per year. Naturally, Mr. Haire and his confederates sit with them on these other boards.

U.S. 739 (1944); 3B Moore, Federal Practice ¶23.1.24[2] at p. 23.1-138.*

Indeed, it is also well settled that where, as here, a majority of the board is charged with wrongdoing or is controlled by a wrongdoer demand pursuant to F.R.C.P. 23.1 is excused. See *Liboff* v. *Wolfson*, 437 F.2d 121, 122 (5th Cir. 1971); *Levitt* v. *Johnson*, 334 F.2d 815, 817 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); *Swanson* v. *Traer*, 249 F.2d 854, 856, 858-59 (7th Cir. 1957); *Cathedral Estates, Inc.* v. *Taft Realty Corp.*, 228 F.2d 85, 88 (2d Cir. 1955); *Jannes* v. *Microwave Communications, Inc.*, 57 F.R.D. 18, 21 (N.D.Ill. 1972); *Barr* v. *Wackman*, 36 N.Y.2d 371, 379, 368 N.Y.S. 2d 497, 505 (1975); Note, "Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit," 73 Harv. L. Rev. 746, 747 (1960). The clear import of these cases (and the many others of similar ilk) is that a *minority* of the board simply cannot prevent derivative actions against a wrongoing majority. Obviously, if the minority cannot prevent commencement, it similarly cannot cause termination.**

* Even if the minority directors had the power to act—which they do not—Rule 23.1 of the Federal Rules of Civil Procedure would itself require prior notice to the shareholders and a judicial determination that dismissal was fair. *Norman* v. *McKee*, 431 F.2d 769, 774 (9th Cir. 1970), *cert. denied*, 401 U.S. 912 (1971). Any such determination could be made only after adequate discovery (*Saylor* v. *Lindsley*, 456 F.2d 896, 904-05 (2d Cir. 1972); *Weiss* v. *Chalker*, 55 F.R.D. 168, 169 (S.D.N.Y. 1972)) and court evaluation of the merits (*Fricke* v. *Daylin, Inc.*, 66 F.R.D. 90 (E.D. N.Y. 1975); *Cannon* v. *Texas Gulf Sulphur Co.*, 55 F.R.D. 308, 315-16 (S.D.N.Y. 1972)). Here, even without any discovery, the Court of Appeals was able to find merit in the pending action.

** The cases cited by Investors Diversified Services hold only that a board of directors may not exercise discretion with respect to derivative litigation unless there is a qualified independent majority. See *Heit* v. *Baird*, 567 F.2d 1157, 1160-61 (1st Cir. 1977); *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 264-65 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973); *Independent Investor Protective League* v. *Saunders*, 64 F.R.D. 564, 571 (E.D. Pa. 1974); *Abrams* v. *Mayflower Investors, Inc.*, 62 F.R.D. 361, 368 (N.D. Ill. 1974); *Lerman* v. *ITB Management Corp.*, 58 F.R.D. 153, 157 (D. Mass. 1973); *Baffino* v. *Bradford*, 57 F.R.D. 79, 80 (D. Minn. 1972). It would make little sense to leave control of the action in the hands of a minority which is subject to great pressure and control by the malefactors who comprise the majority. See *Hall* v. *M.B. O'Reilly Realty & Inv. Co.*, 306 Mo. 182, 196, 267 S.W. 407, 411 (1924); *Tillis* v. *Brown*, 154 Ala. 403, 406-07, 45 So. 589, 590 (1908)

The assertion that the decision below conflicts with the decisions of this Court in *Corbus* v. *Alaska Treadwell Gold Mining Co.*, 187 U.S. 455 (1903) and *United Copper Securities Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261 (1917) is erroneous. These cases simply uphold the general authority of a board of directors to determine whether corporate claims should be pursued. Neither case, however, involved a minority of a board seeking to abort an action validly commenced against a wrongdoing majority. Indeed, in *United Copper* Justice Brandeis stated that a board of directors is without authority to exercise discretion where the wrongdoers control the corporation, as do the individual defendants here. 244 U.S. at 264.

Equally erroneous is the suggestion that the result below conflicts with the decisions of this Court in *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977) and *Cort* v. *Ash*, 422 U.S. 66 (1975). Both *Santa Fe* and *Cort* concerned the question of the existence of implied federal claims which, if recognized, would have overridden substantive state corporate law. In the present case petitioners have never questioned the existence of a federal implied right of action,* which here arises out of the failure of a registered professional to conduct an adequate investigation in connection with a $20 million investment.

* See *Abrahamson* v. *Fleschner*, 568 F.2d 862, 873 (2d Cir. 1977), *cert. denied*, 46 U.S.L.W. 3710 (May 16, 1978) and cases cited therein.

Indeed, this is a traditional area of concern under the federal securities laws. See *Feeney* v. *Securities and Exchange Commission*, 564 F.2d 260, 262 (8th Cir. 1977), *cert. denied*, 46 U.S.L.W. 3649 (Apr. 10, 1978); *Franklin Savings Bank of New York* v. *Levy*, 551 F.2d 521, 527 (2d Cir. 1977); *Hanly* v. *Securities and Exchange Commission*, 415 F.2d 589, 595-97 (2d Cir. 1969); *Matter of Winfield & Co., Inc.*, CCH FED. SEC. L. REP. [1971-72 Transfer Binder] ¶78,530 at p. 81,147 (S.E.C. 1972).

Santa Fe and *Cort* present the issue of whether Congress intended to invade traditional areas of state control of corporate affairs by substantive legislation. The decision below merely prevented petitioners from utilizing a contrived procedural ploy to evade substantive liability arising under federal and state law.*

Indeed, contrary to petitioners' assertions, Delaware law** does not sanction the procedural contrivance attempted by petitioners. Petitioners cite no Delaware case in which a disqualified majority of a board of directors was permitted to delegate to its minority members the authority to act with respect to derivative litigation. To the contrary, under Delaware law, where the litigation, if brought by the corporation itself, would be subject to the control of the alleged wrongdoers a shareholder cannot be precluded from prosecuting the corporate claim. See *Sohland* v. *Baker*, 15 Del. Ch. 431, 441, 141 Atl. 277, 281-82

* Mr. Eisenberg, counsel in this case for the Investment Company Institute, has previously written with respect to the Investment Company Act, and Section 36 in particular, that, "Shareholder rights in such a suit are based on federal law and should not be impeded by corporate or state devices designed to frustrate or unreasonably burden derivative suitors." Eisenberg & Lehr, "An Aspect of the Emerging 'Federal Corporation Law': Directorial Responsibility Under the Investment Company Act of 1940," 20 RUTGERS LAW REV. 181, 225 (1966) (footnotes omitted).

** The Fund is a Delaware corporation.

(1927); *McKee* v. *Rogers*, 18 Del. Ch. 81, 85-86, 156 Atl. 191, 193 (1931); *Satterthwaite* v. *Eastern Bankers' Corp.*, 17 Del. Ch. 310, 312, 154 Atl. 475, 476 (1931).*

It is also clear that under Deleware law directors may not sanction or ratify the perpetration of fraudulent or illegal acts by their co-directors. See *Bennett* v. *Propp*,

* Investors Diversified Services erroneously attributes unfettered control of derivative litigation to the board of a corporation. In support of this overly broad statement it cites *Davis* v. *Louisville Gas & Elec. Co.*, 16 Del. Ch. 157, 142 Atl. 654 (1928); *Ella M. Kelly & Wyndham, Inc.* v. *Bell*, 266 A.2d 878 (Del. 1970); *Moskowitz* v. *Bantrell*, 41 Del. Ch. 177, 190 A.2d 749 (1963); *Beard* v. *Elster*, 39 Del. Ch. 153, 160 A.2d 731 (1960); and *Puma* v. *Marriott*, 283 A.2d 693 (Del. Ch. 1971). However, these cases have nothing to do with board determinations regarding the maintenance of derivative actions, but rather involve the application of the business judgment rule as a substantive defense to charges of directorial misconduct. In fact, federal law controls the question of whether a board of directors is qualified to exercise discretion with respect to derivative litigation seeking the vindication of federal rights in a federal court. See *Meltzer* v. *Atlantic Research Corp.*, 330 F.2d 946, 948-49 (4th Cir.), *cert. denied*, 379 U.S. 841 (1964); *Walden* v. *Elrod*, 72 F.R.D. 5, 13 (W.D. Okla. 1976); *Belcher* v. *Birmingham Trust Nat'l Bank*, 348 F.Supp. 61, 142 (N.D. Ala. 1968). Thus, even if state law conflicted with federal law on this issue, which it does not, federal law would prevail. This is further confirmed by the express provisions of Section 1(a) of the Investment Company Act, 15 U.S.C. §80a-1(a), which provides:

> "(a) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 79z-4 of this title, and facts otherwise disclosed and ascertained, it is found that investment companies are affected with a national public interest in that, among other things—
>
> * * *
>
> (5) the activities of such companies, extending over many States, their use of the instrumentalities of interstate commerce and the wide geographic distribution of their security holders make difficult, if not impossible, effective State regulation of such companies in the interest of investors."

See also *Rosenfeld* v. *Black*, 445 F.2d 1337, 1345 (2d Cir. 1971), *cert. dismissed*, 409 U.S. 802 (1972); Nutt, "A Study of Mutual Fund Independent Directors," 120 U. PA. L. REV. 179, 205 (1971-72).

41 Del. Ch. 14, 187 A.2d 405, 411-12 (1962); *Toebelman* v. *Missouri-Kansas Pipe Line Co.,* 130 F.2d 1016, 1022 (3d Cir. 1942); *Keenan* v. *Eshelman,* 23 Del. Ch. 234, 2 A.2d 904 (1938). That, however, is precisely what the minority sought to accomplish by its decision to abort further judicial consideration of this matter. The Supreme Court of Delaware said in the leading case of *Mayer* v. *Adams,* 37 Del. Ch. 298, 304, 141 A.2d 458, 461 (1958):

> "[A] decision not to press a claim for alleged fraud committed by the directors means, in effect, that the wrong cannot be remedied. It is conceded that the wrong cannot be ratified by the majority stockholders, but it is said that refusal to sue is a different thing from ratification. Strictly speaking, this is true, but the practical result is the same."

Consequently, even under Delaware law, the minority directors cannot ratify the acts in question and thus are without authority to prevent this action from going forward.*

There is no authority under Delaware law which permits directors charged with serious wrongdoing to choose the forum in which they shall be judged, handpick the judge and jury, and in the absence of judicial process be the sole arbiters of what information should be disclosed for consideration in determining their guilt or innocence. That is precisely what was done here, no matter how euphemistically petitioners wish to describe it.

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* See also *Arthur Lipper Corp.* v. *S.E.C.,* 547 F.2d 171, 179 (2d Cir. 1976), *cert. denied,* 46 U.S.L.W. 3436 (Jan. 9, 1978); *Fisher* v. *Nat'l Mortg. Loan Co.,* 132 Neb. 185, 271 N.W. 433 (1937); *Continental Securities Co.* v. *Belmont,* 206 N.Y. 7, 17-19, 99 N.E. 138, 142-43 (1912); Note, "Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit," 73 HARV. L. REV. 746, 762 (1960).

The result below is clearly in accord with well established principles of corporate law governing the maintenance of derivative actions. There is nothing in either the decisions of this Court or of the courts of Delaware which even remotely suggests that petitioners' procedural gambit should succeed. Accordingly, there is no reason why this matter should be reviewed by this Court.

POINT II

There Is No Reason for Review by This Court Since the Result Below Does Not Conflict With Decisions in Other Circuits as to the Proper Role of Mutual Fund Directors. The Decision Is Consistent With the Statutory Scheme of the Investment Company Act and Will Not Create Hardship in the Operation of Mutual Funds.

A. *There Is No Conflict With Other Decisions.*

Petitioners assert that the determination below conflicts with the First Circuit's decision in *In re Kauffman Mutual Fund Actions,* 479 F.2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857 (1973) and with prior decisions within the Second Circuit itself, namely *Fogel* v. *Chestnutt,* 533 F.2d 731 (2d Cir. 1975), *cert. denied,* 429 U.S. 824 (1976) and *Tannenbaum* v. *Zeller,* 552 F.2d 402 (2d Cir.), *cert. denied,* 98 S.Ct. 421 (1977).

Petitioners made the same argument before the Second Circuit in connection with their petition for a rehearing in banc. In denying that petition the Court stated that "no active judge or judge who was a member of the panel . . . requested that a vote be taken . . . ." Thus, petitioners' argument as to alleged conflict was not even deemed sufficiently worthy to warrant that a vote be taken. It is equally

unworthy of consideration by this Court. The purported conflicts simply do not exist.

The *Kauffman* case, chiefly relied upon by petitioners, involved a derivative antitrust claim on behalf of a mutual fund. The issue was whether a demand on the board of directors was excused under F.R.C.P. 23.1.* The court in *Kauffman* upheld the necessity of a demand because, unlike here, a majority of the directors were not defendants in the action and, indeed, were not even alleged to have approved the acts complained of. 479 F.2d at 264-65.

The court in *Kauffman* determined, in effect, that the independent mutual fund directors should have been given an opportunity to exercise discretion. As majority directors not charged with misconduct, they were able to exercise discretion with respect to a demand in the context of Rule 23.1. In the present case, the Second Circuit simply determined that a minority of independent directors could not terminate validly commenced litigation. There is no conflict between the two decisions.**

Nor does the decision below conflict with the *Fogel* and *Tannenbaum* cases, both of which dealt with the matter of recapture of brokerage fees. Neither *Fogel* nor *Tannen-*

* As previously indicated, and as noted by the District Court, defendants here have never disputed the fact that a demand in the instant case was excused. See *Lasker* v. *Burks,* 404 F.Supp. 1172, 1178 (S.D.N.Y. 1975).

** *Kauffman* was recently reaffirmed by the First Circuit in *Heit* v. *Baird,* 567 F.2d 1157, 1160 n.4 (1st Cir. 1977), wherein the court expressly noted that, "*Kauffman* has been cited with approval by the Second Circuit, where many derivative suits are brought." Similarly, in *Brooks* v. *American Export Industries, Inc.,* 68 F.R.D. 506, 510 (S.D.N.Y. 1975) the district court observed that, "The *Kauffman* case, which discusses in detail the extent of the 'futility' exception, has been repeatedly cited with approval by the Second Circuit."

baum involved the issue of discretionary authority to terminate derivative litigation and in neither case did the wrongdoing defendants constitute a majority of the board of directors. 533 F.2d at 746n.15; 552 F.2d at 411.*

The gravamen of the offense in these cases was management's failure to make full and effective disclosure to the independent directors concerning the availability of recapture through various business mechanisms. The court found that full disclosure had to be made to the independent directors (who constituted a majority) and then noted that once such disclosure was made, the question of whether to pursue recapture could be determined by the independent directors provided that they were in fact independent.

The issue in these recapture cases was not whether suit should be brought for past wrongs but whether certain business steps should be taken to obtain future benefits. In the case at bar the question presented is whether suit should proceed against Anchor for its prior illegal and fraudulent acts. The Second Circuit here held that a minority of the board could not prevent suit. Indeed, in both *Fogel* and *Tannenbaum,* the Court indicated that once a wrong has been committed, as it was here, it may not be excused, ratified or condoned by subsequent acts, expressions or determinations of the independent directors. 533 F.2d at 750; 552 F.2d at 429n.31. See also *Arthur Lipper Corp.* v. *S.E.C.,* 547 F.2d 171, 179 (2d Cir. 1976), *cert. denied,* 46 U.S.L.W. 3436 (Jan. 9, 1978), where the Court stated:

* Similarly, in neither of the other two cases cited by the *amici curiae* with respect to a purported conflict did the wrongdoing defendants constitute a majority of the board. See *Moses* v. *Burgin,* 445 F.2d 369, 371 (1st Cir.), *cert. denied,* 404 U.S. 994 (1971); *Untermeyer* v. *Fidelity Daily Income Trust,* CCH Fed. Sec. L. Rep. ¶96,419 at 93,512-13 (D. Mass. 1978).

"Moreover, it is not within the competence of a board of directors of an investment company to sanction the perpetration of a fraud by the manager. *Cf. Schoenbaum* v. *Firstbrook, supra,* 405 F.2d at 219-20; *Drachman* v. *Harvey,* 453 F.2d 722, 736-38 (2 Cir. 1972) (*en banc*). Indeed, it would seem that only a unanimous shareholder vote could ratify a fraud of this type even if approved by directors. See Ballantine on Corporations §71, at 177 (rev. ed. 1946); Cary, Cases and Materials on Corporations 591-92 (1969); Lattin, Jennings & Buxbaum, Corporations 821 (1968 ed.); *Keenan* v. *Eshelman,* 23 Del. Ch. 234, 2 A.2d 904 (Sup. Ct. 1938); *Continental Securities Co.* v. *Belmont,* 206 N.Y. 7, 99 N.E. 138 (1912)."

There is no conflict between the decisions of the Second Circuit in *Tannenbaum* and *Fogel* and the decision of that circuit in this case.

B. *The Decision Below Is Consistent With the Statute and Creates No Undue Problems.*

Petitioners and the *amici curiae* argue that the Court of Appeals misconstrued the Investment Company Act, particularly the 1970 amendments thereto, and in so doing undermined the watchdog function intended by Congress for independent mutual fund directors. This argument lacks any basis whatsoever.

As previously demonstrated, an independent minority of a board of directors of a business corporation is without power, under federal or state decisional law, to obtain dismissal of derivative litigation. The question which the Court of Appeals focused upon in the present case was whether the Investment Company Act conferred special power on minority independent mutual fund directors so as to permit them to abort a derivative action in a situation where directors of other kinds of business corporations could not do so. The Court not only found that such power did not exist, but rather found that the policy of the Act militated against it. The Court stated:

"We see nothing in the findings of Congress, the legislation regulating investment companies and their advisers, or in the decisions of the courts which suggests that under such circumstances disinterested directors, such as the five who acted here, have the power to terminate litigation brought by mutual fund stockholders against the fund's investment adviser and its majority directors for breach of their fiduciary duties. On the contrary, the findings of Congress, the statutory scheme, and the relevant case law persuade us that the statutorily disinterested directors of a registered investment company were never meant to have the final word in determining whether it is in the best interest of a mutual fund to press claims against their co-directors, and the adviser with which those directors are affiliated, for breach of fiduciary duties." 567 F.2d at 1210.*

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* Congress mandated in Section 1(b) of the Investment Company Act, 15 U.S.C. §80a-1(b), that the Act be interpreted so as to maximize the protection of shareholder interests, particularly where, as here, those interests directly conflict with the financial interests of the managing directors and the investment adviser. The Act provides:

"(b) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 79z—4 of this title, and facts otherwise disclosed and ascertained, it is declared that the national public interest and the interest of investors are adversely affected—

• • •

(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes

Petitioners and the *amici* suggest that the Court of Appeals imputed into the provisions of Section 36(a) the broader provisions of Section 36(b) with respect to the commencement of derivative actions. This argument is specious because those statutory provisions were not even in existence when the wrongs at bar occurred and this case does not rest upon them but rather upon Section 36 as it read prior to its amendment effective December 1970.

As suggested by petitioners and the *amici*, the 1970 amendments were intended to strengthen the role of in-

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of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

• • •

It is declared that the policy and purposes of this subchapter, in accordance with which the provisions of this subchapter shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors."

See *Levitt* v. *Johnson*, 334 F.2d 815 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965). Moreover, under Section 17(h) of the Act, 15 U.S.C. §80a-17(h), Congress specifically prohibited clauses in corporate instruments, including the by-laws, which protect or purport to protect mutual fund directors from liability. Section 17(h) states in part:

"(h) After one year from the effective date of this subchapter, neither the charter, certificate of incorporation, articles of association, indenture of trust, nor the by-laws of any registered investment company, nor any other instrument pursuant to which such a company is organized or administered, shall contain any provision which protects or purports to protect any director or officer of such company against any liability to the company or to its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office."

See *Chabot* v. *Empire Trust Co.*, 301 F.2d 458 (2d Cir. 1962); *Brown* v. *Bullock*, 194 F.Supp. 207, 237-38 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961).

dependent directors in dealing with the adviser.* Nothing in the language or legislative history of those sections, however, can be construed as granting independent directors extraordinary powers to curtail existing shareholder rights, including the right to sue derivatively. The creation of a watchdog role for the independent directors cannot and should not be distorted into the creation of a power to exculpate wrongdoing directors under the guise of business judgment.

In its brief to this Court, the Investment Company Institute asserts that maintenance of this action will somehow impair Anchor's ability to function as the Fund's adviser. To the contrary, Mr. Haire testified at his deposition:

> "Q. Did you have an opinion whether your firm, Anchor, could continue as the adviser in the event these five people decided to continue the suit against you?
>
> A. I certainly did. I would have argued most vigorously that we could continue to serve.
>
> Q. That you could?
>
> A. That is correct."

Petitioners and the *amici* suggest that the effect of the Court of Appeals' decision will be to encourage unfounded

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* A primary purpose of the 1970 amendments was to strengthen the negotiating hand of the independent directors vis-a-vis the adviser by making it clear that a shareholder's right of action would lie in the event the advisory or underwriting fees were excessive. See S. Rep. No. 91-184, 91st Cong., 2d Sess., *reprinted in* 3 U.S. Code Cong. & Admin. News 4897, 4901-4903 (1970). The decision by the Court of Appeals in this case has done nothing to impair the strengthened position of the independent directors nor to impede the fulfillment of the congressional purposes behind the 1970 amendments. To the contrary, it has bolstered that position.

suits against investment advisers each time an investment results in a loss. The simple fact, however, is that the present action is "nonfrivolous" and is based upon established statutory and common law standards. How the permitted maintenance of a nonfrivolous action will encourage unfounded actions is nowhere explained. Concededly, litigation causes some corporate disruption. However, the Investment Company Act, Rule 23.1 and the common-law sanction derivative claims such as the one at bar.

Investors Diversified Services predicts a vast expansion in mutual fund derivative litigation because, in its view, the Court of Appeals has created a presumption that "independent" directors are not sufficiently disinterested to abate nonfrivolous derivative actions. No such presumption was created. Rather, the Court ruled that on the specific facts at bar,

> ". . . it cannot be expected that the public or the Fund's stockholders would believe that these five statutorily disinterested directors could act with that impartiality and objectivity which the public interest requires." 567 F.2d at 1212.

In reaching this conclusion, the Court was motivated by at least four factual considerations: (1) the quorum which made the determination constituted only a minority of the board; (2) the Fund is a corporate shell, organized, administered and controlled by Anchor and the majority defendants; (3) the independent directors were selected, nominated and held office at the pleasure of the majority defendants; and (4) the minority directors received remuneration of from $11,000 to $13,000 per year for serving on the Fund's board and the boards of six other Anchor controlled corporations. The Court's conclusion

that independent directors of mutual funds "do not have the power to foreclose the continuance of nonfrivolous litigation brought by shareholders against majority directors" is merely a recognition of the corporate reality that in such a situation effective control rests with the parties charged with the wrongdoing.* Thus, while the decision may be couched in terms of the Investment Company Act it is basically a corporate law determination founded on the most well settled general principles. See *Liboff* v. *Wolfson, supra,* 437 F.2d at 122; *Cathedral Estates, Inc.* v. *Taft Realty Corp., supra,* 228 F.2d at 86; *Dopp* v. *American Electronic Laboratories, Inc.,* 55 F.R.D. 151 (S.D.N.Y. 1972); *Cohen* v. *Industrial Finance Corp.,* 44 F. Supp. 491 (S.D.N.Y. 1942); *Ripley* v. *Internat. Rys. of Cent. Amer.,* 8 App. Div. 2d 310, 314-18, 188 N.Y.S.2d 62, 69-73 (1st Dep't 1959), *aff'd,* 8 N.Y.2d 430, 209 N.Y.S. 2d 289 (1960). See also *Commonwealth Coatings Corp.* v. *Continental Casualty Co.,* 393 U.S. 145 (1968); *Borden* v. *Sinskey,* 530 F.2d 478, 495 (3d Cir. 1976).

There is no basis for the argument that the present decision will expand derivative litigation.

Finally, Investors Diversified Services argues that the procedure employed by the Fund's board for the review and dismissal of this case is a viable, and indeed preferable, alternative to the demand procedures embodied in F.R.C.P. 23.1. The argument is devoid of substance. If the procedure suggested by IDS were sanctioned, Rule 23.1 would be rendered meaningless. A derivative plain-

* In a mutual fund control of the board obviously carries full control of the proxy machinery and the corporation. Wharton School of Finance & Commerce, *A Study of Mutual Funds,* H.R. REP. No. 2274, 87th Cong., 2d Sess. at 64 (1962); Securities & Exchange Commission, *Public Policy Implications of Investment Company Growth,* H.R. REP. No. 2337, 89th Cong., 2d Sess. at 129-30 (1966)

tiff could enter the courthouse one day by successfully pleading futility of demand against a wrongdoing majority only to find himself being escorted out the courthouse door at some subsequent point in the litigation by a minority of the same disqualified board. The potential for abuse would be enormous. A controlling majority of defendant directors could create a disinterested quorum after the litigation had commenced by rotating themselves out of office until a quorum perceived as friendly were available to exercise business judgment. As stated by the court in *Cohen* v. *Industrial Finance Corp., supra:*

> "The court should not cajole itself into believing that the members of a Board of Directors elected by the dominant and accused majority stockholder, after accusations of wrongoing have been made, were selected for membership on the Board to protect the interests of the minority stockholders and to assure a vigorous prosecution of effective litigation against the offending majority." 44 F.Supp. at 494.

See also *Meltzer* v. *Atlantic Research Corp.,* 330 F.2d 946, 949 (4th Cir.), *cert. denied,* 379 U.S. 841 (1964).*

* If the procedure in question were sanctioned, it would be almost impossible to ferret out abuses on a case by case basis, particularly as regards mutual funds. The court in *Boyko* v. *The Reserve Fund, Inc.*, 68 F.R.D. 692, 696 (S.D.N.Y. 1975), stated, "[T]angible indications of bias on the part of the unaffiliated majority [here, minority] are rarely present. As stated in the legislative history, control of a mutual fund by its adviser is the result of intangible factors arising out of the unique structure of the industry." One commentator put the matter as follows: "[O]bviously you know and I know that if you are choosing an unaffiliated director or an independent director you are not going to choose anybody who is going to be too hard on you. You are going to tend to pick a friend of yours. . . ." *Conference on Mutual Funds,* 115 U. Pa. L. Rev. 662, 739 (1967) (remarks of Abraham L. Pomerantz). See also Nutt, "A Study of Mutual Fund Independent Directors," 120 U. Pa. L. Rev. 179, 216 (1971-72); Wharton School of Finance and Commerce, *A Study of Mutual Funds,* H.R. Rep. No. 2274, 87th Cong., 2d Sess. 465-66 (1962).

APPENDIX

Contrary to the argument put forth by Investor Diversified Services, had the procedure adopted by the Fund's board been judicially sanctioned, it would have provided an effective device for the frustration of shareholder enforcement of important federal prophylactic legislation and a means for corporate fiduciaries to absolve themselves from serious charges of wrongdoing.

CONCLUSION

For the foregoing reasons, the petition should be denied.

Respectfully submitted,

Joseph H. Einstein
Attorney for Respondents

Aranow Brodsky Bohlinger
Benetar & Einhorn
Steven Mallis
Herbert A. Einhorn
David J. Sweet
Terence L. Blackburn
Of Counsel

APPENDIX

Investment Company Act of 1940

§13. Changes in investment policy

(a) No registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities—

* * *

(3) deviate from its policy in respect of concentration of investments in any particular industry or group of industries as recited in its registration statement, deviate from any investment policy which is changeable only if authorized by shareholder vote, or deviate from any policy recited in its registration statement pursuant to section 80a—8(b) (3) of this title:

§36. Breach of fiduciary duty [Effective prior to December 14, 1970]

The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has been guilty, after August 22, 1940, and within five years of the commencement of the action of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts—

(1) as officer director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If the Commission's allegations of such gross misconduct or gross abuse of trust are established, the court shall

enjoin such person from acting in such capacity or capacities either permanently or for such period of time as it in its discretion shall deem appropriate.

Investment Advisers Act

§206. Prohibited transactions by investment advisers

It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction;

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

Federal Rules of Civil Procedure

Rule 23.1 Derivative Actions by Shareholders

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.